

## Message Text

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ACTION TRSE-00

INFO OCT-02 EA-10 ISO-00 NEA-10 IO-13 L-03 H-01 PA-01  
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USADB

FOR NAC AGENCIES

PASS TREASURY FOR BRADFORD

E.O. 11652: NA  
TAGS: EAID, EFIN  
SUBJECT: REVIEW OF ADB FINANCIAL POLICIES

SUMMARY: ADB MANAGEMENT HAS ISSUED ITS ANNUAL REVIEW OF  
BANK'S FINANCIAL POLICIES IN LIGHT OF DEVELOPMENTS IN 1977  
AS THEY RELATE TO ORDINARY CAPITAL (OC) RESOURCES. PAPER  
CONSIDERS LENDING FOR 1978-1981 AND FINANCIAL  
OBJECTIVES AND POLICIES IN LIGHT OF REVISED FINANCIAL  
PROJECTIONS. TWO MAJOR RECOMMENDATIONS CALL FOR REDUCTION  
IN OC LENDING RATE FROM 8.30 PERCENT TO 7.75 PERCENT PER  
ANNUM AND INCREASE IN COMMITMENT CHARGE ON LOANS FROM  
0.45 TO 0.75 PERCENT PER ANNUM EFFECTIVE 1 JANUARY 1978.  
A THIRD SIGNIFICANT PROPOSAL IS TO INCREASE LENDING  
PROGRAM DURING THIS FOUR-YEAR PERIOD BY \$200 MILLION OVER  
AND ABOVE THAT PROPOSED EARLIER. USADB RECOM-  
MENTS WE ACCEPT (A) PROPOSED \$200 MILLION INCREASE IN  
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1978-1981 LENDING PROGRAM BUT WITH A SLOWER PHASE-IN  
TO ENSURE THAT QUALITY OF LOANS WILL NOT BE IMPAIRED;  
(B) PROPOSED REDUCTION IN LENDING RATE; (C)  
MANAGEMENT PROPOSAL CONCERNING CHANGES IN LENDING RATE  
FOR REMAINDER OF 1978; AND (D) PROPOSED INCREASE IN  
COMMITMENT CHARGE. NAC GUIDANCE REQUESTED. END SUMMARY.

1. ADB MANAGEMENT'S NEWLY ISSUED ANNUAL FINANCIAL POLICIES REVIEW PAPER CONSIDERS BANK'S LENDING PROGRAM FOR 1978-1981 WITH RESPECT TO OC RESOURCES AND FINANCIAL OBJECTIVES AND POLICIES RELATING TO LIQUIDITY, BORROWINGS, COMMITMENT CHARGE AND DETERMINATION OF LENDING RATE. MAIN ITEMS ARE DISCUSSED BELOW.

2. OC LENDING PROGRAM 1978-1981: DURING LAST YEAR'S FINANCIAL POLICIES REVIEW, SOME BOARD MEMBERS EXPRESSED VIEW THAT ASSUMED INCREASE IN OC LENDING BY \$75 MILLION PER ANNUM WAS NOT SUFFICIENT. AFTER CONSIDERING BORROWING COVENANTS, LIQUIDITY ASPECTS AND DISBURSEMENT TRENDS, BANK HAS CONCLUDED THAT IT COULD PRUDENTLY PLAN FOR AN ADDITIONAL COMMITMENT OF ABOUT \$200 MILLION DURING 1978-1981 PERIOD OVER AND ABOVE LEVELS PROJECTED EARLIER, OF WHICH \$50 MILLION MIGHT BE ADDED TO PRESENT \$700 MILLION PROJECTION FOR CURRENT YEAR. (IF REALIZED, PROPOSED LENDING WOULD EFFECTIVELY INCREASE BY \$135 MILLION FROM \$615 MILLION LEVEL ACTUALLY REACHED IN 1977. THIS LEVEL, ACCORDING TO BANK PAPER, IS REASONABLE FROM POINTS OF VIEW OF COUNTRY PROGRAMMING AND PROJECT PIPELINE.) SITUATION WOULD BE SUBJECT TO REVIEW FROM YEAR TO YEAR IN LIGHT OF SUCH FACTORS AS DISBURSEMENTS AND LIQUIDITY. DOCUMENT ASSERTS THAT PROPOSED ADDITIONAL COMMITMENT OF \$200 MILLION DURING 1978-1981 PERIOD WOULD NOT SIGNIFICANTLY AFFECT NEED FOR AND LIKELY LIMITED OFFICIAL USE

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TIMING OF THIRD GENERAL CAPITAL INCREASE.

3. FINANCIAL OBJECTIVES AND INDICATORS: IN LAST YEAR'S FINANCIAL POLICY REVIEW, IT WAS AGREED THAT BANK'S MOST SIGNIFICANT FINANCIAL INDICATORS -- INTEREST COVERAGE RATION (WHICH IS SUM OF NET INCOME AND INTEREST EXPENSES DIVIDED BY INTEREST EXPENSES) AND RESERVE: LOAN RATION -- SHOULD BE MAINTAINED AT NOT LESS THAN 1.25 AND 15 PERCENT, RESPECTIVELY, TO ENSURE A SATISFACTORY FINANCIAL POSITION. IT IS PROPOSED THAT THESE AND OTHER FINANCIAL OBJECTIVES AND CRITERIA APPROVED IN 1977 SHOULD CONTINUE UNCHANGED.

4. LIQUIDITY POLICY: LAST YEAR'S APPROVED LIQUIDITY FORMULA STATES THAT PROJECT YEAR-END LIQUIDITY SHOULD BE EQUIVALENT TO HIGHER OF EITHER (A) THE SUM OF PROJECTED GROSS DISBURSEMENTS OF FOLLOWING YEAR AND ONE-HALF OF PROJECTED GROSS DISBURSEMENTS OF THE NEXT SUCCEEDING YEAR OR (B) 50 PERCENT OF UNDISBURSED

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LOAN BALANCES AT THE END OF THE YEAR UNDER CON-  
SIDERATION. PAPER NOTES THAT BEING RELATED TO UNDIS-  
BURSED LOAN BALANCES, THE LOWER THE PROJECTED DISBURSE-  
MENTS, THE HIGHER THE PROJECTED UNDISBURSED LOAN  
BALANCES AND CONSEQUENTLY THE HIGHER PROJECTED  
LIQUIDITY REQUIREMENTS. THEREFORE, IN ORDER TO MITIGATE  
TO EXTENT POSSIBLE ANY BUILT-IN TENDENCY IN LIQUIDITY  
FORMULA FOR A SUBSTANTIALLY HIGHER LEVEL OF PROJECTED  
LIQUIDITY THAN ACTUALLY NEEDED, BANK MANAGEMENT PROPOSES  
TO REDUCE (B) ABOVE FROM 50 PERCENT TO 40 PERCENT OF  
UNDISBURSED LOAN BALANCES.

5. ANOTHER LIQUIDITY POLICY CONCLUSION REACHED LAST  
YEAR WAS THAT ACTUAL PROGRAM OF ANNULA BORROWINGS SHOULD  
BE CONSIDERED IN A THREE-YEAR ROLLING FRAMWORK, WITH  
BORROWINGS DURING FIRST YEAR LIMITED TO UP TO 25 PERCENT  
OF TOTAL THREE-YEAR REQUIREMENTS. POLICY OF  
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PHASED BORROWING ACTIVITIES OVER THREE-YEAR PERIOD IS  
RECOMMENDED TO BE CONTINUED THIS YEAR. HOWEVER, THERE

WERE SUGGESTIONS FROM SOME BOARD MEMBERS LAST YEAR THAT, IN VIEW OF UNCERTAIN CONDITIONS IN CAPITAL MARKETS, A PERCENTAGE OF 33-1/3 COULD BE PERMITTED DURING FIRST YEAR. TAKING INTO CONSIDERATION THIS SUGGESTION, AND THE MORE CONSERVATIVE APPROACH TO LIQUIDITY PROPOSED IN PARA 4 ABOVE, MANAGEMENT SUGGESTS IT SEEMS JUSTIFIABLE TO ADOPT A PERCENTAGE OF 33-1/3 FOR THE FIRST YEAR OF THE THREE YEAR ROLLING PROGRAM. ON PRESENT CALCULATIONS, PAPER INDICATES THERE WOULD BE A STEADY AND MANAGEABLE INCREASE FROM YEAR TO YEAR IN THE RESULTANT PHASED BORROWING PROFILE.

6. BORROWINGS: ON BASIS OF PHASING OF BORROWINGS SUGGESTED IN PARA. 5 ABOVE, PAPER INDICATES THAT RATIO OF OUTSTANDING BORROWINGS TO CALLABLE CAPITAL IN CONVERTIBLE CURRENCIES DURING 1978-1981 WOULD NOT EXCEED THE BANK'S SELF-IMPOSED 75 PERCENT CEILING. (EXISTING COVENANTS LIMIT BORROWINGS TO 100 PERCENT OF CALLABLE CAPITAL IN CONVERTIBLE CURRENCIES.)

7. COMMITMENT CHARGE: LAST YEAR SEVERAL BOARD MEMBERS (LED BY U.S. AND AUSTRALIAN EXECUTIVE DIRECTORS) URGED THAT RATE OF COMMITMENT CHARGE OF 0.45 PERCENT PER ANNUM BE INCREASED. (THIS CHARGE, WHICH IS LEVIED ON UNDISBURSED PORTION FROM 60 DAYS AFTER SIGNING OF LOAN AGREEMENT, IS MEANT TO COMPENSATE BANK FOR HAVING TO KEEP ITS INVESTMENTS OF SURPLUS FUNDS IN SUFFICIENTLY LIQUID FORM TO MEET READILY DISBURSEMENT DEMANDS FROM BORROWERS, ONCE A LOAN IS APPROVED.) ARGUMENT IS MADE THAT HIGHER RATE WOULD RESULT IN QUICKER DISBURSEMENT WHICH HAS BEEN BIG PROBLEM FOR BANK IN RECENT YEARS. PAPER LIMITED OFFICIAL USE

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RECOMMENDS THAT COMMITMENT CHARGE ON LOANS OTHER THAN THOSE MADE EXCLUSIVELY FOR ENGINEERING AND TECHNICAL ASSISTANCE BE INCREASED TO 0.75 PERCENT, WHICH SHOULD HAVE ONLY INSIGNIFICANT IMPACT ON BORROWERS AND WOULD BRING CHARGE IN LINE WITH THAT CHARGED BY IBRD. IT WOULD ALSO BRING LENDING RATES OF IBRD AND ADB NEARER TO A DIRECTLY COMPARABLE BASIS.

8. DETERMINATION OF LENDING RATE: FORMULA APPROVED BY BOARD IN 1977 FOR DERIVING BANK'S LENDING RATE WAS THE SUM OF (A) THE AVERAGE BORROWING COST ACTUALLY INCURRED BY BANK OVER PAST TWELVE MONTHS, NORMALIZED TO AN AVERAGE MATURITY OF 8 YEARS, AND (B) A CHARGE (POSITIVE SPREAD) WHICH REFLECTS THE IMPACT ON THE LENDING RATE OF ADMINISTRATIVE EXPENSES OF BANK IN ITS ORDINARY LOAN OPERATIONS. DURING LAST YEAR'S BOARD DISCUSSION, SEVERAL MEMBERS HAD OBSERVED THAT, IF THE

NUMBER AND AMOUNT OF BORROWINGS MADE DURING A 12-MONTH PERIOD PRECEDING DATE OF LENDING RATE REVIEW WERE MEAGER, THE NORMALIZED AVERAGE COST OF SUCH BORROWINGS COULD NOT BE AN ADEQUATE BASIS FOR DETERMINING LENDING RATE. RE METHOD OF COMPUTING ADMINISTRATIVE CHARGE OF 0.28 PERCENT WHICH FORMED BASIS FOR LENDING RATE OF 8.70 PERCENT PER ANNUM PROPOSED TO BOARD IN MARCH 1977, SOME BOARD MEMBERS FELT THAT FORMULA DID NOT REFLECT FULLY ALL THE ADMINISTRATIVE EXPENSES AND THUS IMPLIED A SUBSIDY OF SUCH EXPENSES.

9. WITH REGARD TO ARGUMENT THAT INSUFFICIENT BORROWING

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IN ANY ONE YEAR IS NOT ADEQUATE BASIS FOR DETERMINING LENDING RATE, BANK PAPER SUGGESTS THAT NO ONLY ACTUAL BORROWINGS MADE IN LAST 12 MONTHS BUT ALSO HYPOTHETICAL BORROWINGS DURING THAT PERIOD COULD BE INCLUDED IN COMPUTING NORMALIZED COSTS. ON ISSUE OF AMOUNT OF ADMINISTRATIVE CHARGE, PAPER STATES THAT ANY SUBSIDY IN OC OPERATIONS SHOULD BE GEARED TO ACTUAL RETURN ON EQUITY IN RELATION TO WHAT MIGHT BE CONSIDERED APPROPRIATE FOR THIS PURPOSE AND NOT TO FORMULA USED TO DETERMINE BANK'S LENDING RATE. PAPER THAN SUGGESTS

AS A MORE APPROPRIATE METHOD OF ALLOWING FOR IMPACT OF ADMINISTRATIVE EXPENSES ON LENDING RATE IN COMPUTING SPREAD COULD BE TO CONSIDER LOAN COMMITMENTS IN RELATION TO BORROWED FUNDS AND EQUITY. IN THIS METHOD, THE RELATIVE LEVELS OF BANK'S PAID-IN CAPITAL AND INTERNALLY GENERATED FUNDS (RESERVES) AS WELL AS BANK'S BORROWED RESOURCES HAVE THEIR IMPACT ON THE LEVEL OF THE SPREAD.

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10. PAPER THEN COMPUTES NORMALIZED AVERAGE BORROWING COST OF ACTUAL AND HYPOTHETICAL BORROWINGS IN 1977 (TALLING \$260 MILLION) WHICH WORKS OUT TO 7.47 PERCENT. TO THIS AMOUNT IS ADDED THE SPREAD OF 0.30 PERCENT, CALCULATED IN ACCORDANCE WITH PARA. 9 ABOVE, WHICH RESULTS IN LIKELY LEVEL OF APPROPRIATE LENDING RATE FOR 1978 OF 7.77 PERCENT. PAPER THEREFORE CONCLUDES THAT APPROPRIATE LENDING RATE SHOULD BE FIXED AT 7.75 PERCENT PER ANNUM WITH EFFECT FROM JANUARY 1, 1978.

11. QUITE CLEARLY, AN IMPORTANT CONSIDERTION IN DETERMINING BANK'S LENDING RATE IS LENDING RATE OF IBRD. IT SEEMS TO BE GENERAL VIEW THAT THERE SHOULD BE A CLOSE RELATIONSHIP BETWEEN THE TWO. IN THIS CONNECTION, BANK PAPER NOTES THAT IBRD RATE HAS BEEN SET AT 7.45 PERCENT AS OF JANUARY 1, 1978.

12. ON ADDITIONAL ISSUE BEING ADDRESSED IN BANK PAPER RELATES TO CHANGES IN LENDING RATE DURING THE YEAR. MANAGEMENT FEELS THAT, WHILE IT IS NOT APPROPRIATE TO RELATE BANK'S LENDING RATE EXCLUSIVELY TO THAT OF IBRD, EXPERIENCE HAS SHOWN THAT IT IS NOT ADVISABLE TO IGNORE ALTOGETHER THE LEVEL OF AND CHANGES IN IT FROM TIME TO TIME. PAPER THEN PRESENTS FORMULA WHEREBY BANK'S RATE FOR 1978 WOULD REMAIN UNCHANGED DURING THE YEAR SO LONG AS DIFFERENTIAL BETWEEN TWO RATES DOES NOT INCREASE OR DECREASE BY MORE THAN 5 BASIS POINTS (0.05 PERCENT). IF IBRD RATE CHANGES BY MORE THAN 5 BASIS POINTS IN SECOND QUARTER (I.E., BY AT LEAST 10 BASIS POINTS), BANK'S LENDING RATE WOULD AUTOMATICALLY INCREASE OR DECREASE, AS CASE MAY BE, BY 10 BASIS POINTS ONLY. PAPER SUGGESTS THAT THIS AUTOMATIC REVISION WILL MAINTAIN

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SOME DEGREE OF CORRELATION BETWEEN LENDING RATES OF THE TWO INSTITUTIONS WITHOUT UNDULY INFLUENCING THE BANK'S

FINANCIAL INDICATORS. IF, DURING THEIRD AND FOURTH  
CALENDAR QUARTER, DIFFERENTIAL BETWEEN TWO  
LENDING RATES INCREASES BY MORE THAN 10 BASIS POINTS  
BEYOND THAT EXISTING IN FIRST QUARTER OF THIS YEAR, THE  
POSITION MAY BE REVIEWED AND SUITABLE PROPOSALS SUBMITTED  
TO THE BOARD OF DIRECTORS.

13. USADB COMMENT: BELIEVE WE SHOULD FOCUS OUR ATTENTION  
ON COMMITMENT CHARG, LENDING RATE AND PROPOSED INCREASE  
IN BANK'S LENDING PROGRAM. ON COMMITMENT CHARGE, WE  
NOTE THAT PROPOSAL FOR AN INCREASE TO 75 BASIS POINTS IS  
SAME AS THAT RECOMMENDED BY U.S. GOVERNOR IN HIS SPEECH  
AT LAST YEAR'S ANNUAL MEETING IN MANILA. PROPOSED 7.75  
LENDING RATE WILL RESULT IN SPREAD BETWEEN IBRD AND ADB  
RATES OF 30 BASIS POINTS. THIS COMPARED WITH  
20 POINT SPREAD IN JANUARY 1977 AND WOULD BE EQUAL TO  
SPREAD OF 30 BASIS POINTS WHEN ADB BOARD OF DIRECTORS SET  
8.30 PERCENT LENDING RATE FOR SECOND HALF OF 1977.

14. U.S. ED HAS HELD INFORMAL DISCUSSIONS WITH EXECUTIVE

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DIRECTORS FROM AUSTRALIA, CANADA/SCANDINAVIA AND UNITED  
KINGDOM/GERMANY. ALL AGREE THAT BANK IS FINANCIALLY

CAPABLE OF INCREASING ITS OC LOAN COMMITMENT LEVEL BY PROPOSED \$200 MILLION. HOWEVER, WE WOULD PREFER TO SEE A LESS RAPID PHASING IN OF THE TOTAL AMOUNT IN ORDER TO ENSURE THAT QUALITY OF LOANS WILL NOT BE IMPAIRED. THUS, ON BASIS OF GENERAL ADMINISTRATIVE EFFICIENCY AND MEETING LOAN REQUIREMENTS IN 1978, WE BELIEVE FIGURE OF \$135 MILLION OVER ACTUAL 1977 OC LENDING IS TOO LARGE. GROUP WAS INCLINED TO ADJUST PROPOSED 1978-1981 MILLION LENDING PROGRAM IN TABLE 2 OF BANK DOCUMENT AS FOLLOWS: 1978 - FROM \$750 MILLION TO \$700 MILLION; 1979 - FROM \$825 MILLION TO \$795 MILLION; 1980 - FROM \$900 MILLION TO \$910 MILLION; AND 1981 - FROM \$975 MILLION TO \$1,045 MILLION.

15. AUSTRALIAN ED BELIEVES THT PROPOSED LENDING RATE LIMITED OFFICIAL USE

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IS HIGHER THAN IT NEED BE BECAUSE (A) ESTIMATE OF ADDITIONAL COST OF BORROWING BY ADB OVER IBRD IS TOO HIGH BECAUSE ADB BORROWS MORE HEAVILY IN JAPAN (WHERE COST IS THE SAME FOR BOTH INSTITUTIONS) AND SWITZERLAND (WHERE DIFFERENTIAL IS SMALLER THAN IN UNITED STATES CAPITAL MARKET) AND (B) ADB IS MORE PRUDENTLY MANAGED THAN IBRD AND DOES NOT GET INVOLVED IN MANY FUNCTIONS THAT RAISE IBRD ADMINISTRATIVE COSTS (E.G., RESEARCH, TRAINING, INFLATED STAFFING, ETC.). EDS FROM CANADA AND U.K. ARE INCLINED TO ACCEPT MANAGEMENT'S RECOMMENDATION ON LENDING RATE AND DO NOT FEEL IT IS TOO HIGH. RE 30 BASIS POINT ADMINISTRATIVE CHARGE, THERE WAS SOME SKEPTICISM AS TO ITS ACCURACY BUT ACCEPTANCE OF VIEW THAT ADMINISTRATIVE COSTS OF ADB ARE LESS THAN THOSE OF IBRD.

16. THERE WAS ALSO GENERAL AGREEMENT AS TO NEED TO FOLLOW IBRD IF LATTER MADE SUBSTANTIAL CHANGES IN LENDING RATE. CANADIAN ED FELT STRONGLY THAT THERE SHOULD BE A DIRECT AND COMPLETE LINKAGE WITH IBRD FOR BALANCE OF 1978, ONCE BANK'S NEW LENDING RATE HAS BEEN ESTABLISHED. OTHER TWO EDS FAVOR MANAGEMENT PROPOSAL WHICH PROVIDES A MODICUM OF INDEPENDENCE OF IBRD.

17. WE PROPOSE THAT WE BE GIVEN AUTHORITY TO CONCUR IN PROPOSED LENDING RATE BUT TO OPPOSE ANY DMC, OR POSSIBLE AUSTRALIAN PRESSURE FOR A LOWER RATE. WE ARE PREPARED TO ACCEPT THE \$200 MILLION ADDITIONAL COMMITMENT DURING 1978-1981 BUT WOULD SUPPORT THE ALTERED ANNUAL DISTRIBUTION (PARA. 14 ABOVE) SO THAT BANK WOULD NOT HAVE TO DIGEST SO MUCH IN 1978. WE ALSO RECOMMEND ACCEPTING MANAGEMENT'S PROPOSAL CONCERNING CHANGES IN LENDING RATE FOR REMAINDER OF 1978, WHICH HAS CONSIDERABLE ADVANTAGE OF AVOIDING



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REOPENING OF THIS QUESTION AGAIN THIS YEAR UNLESS THERE  
IS WIDE SHIFT IN IBRD'S LENDING RATE IN THIRD OR FOURTH  
QUARTERS. FINALLY, WE SUPPORT PROPOSED COMMITMENT CHARGE  
WHICH IS CONSISTENT WITH POSITION ENUNCIATED BY U.S.  
GOVERNOR AT 1977 ADB ANNUAL MEETING IN MANILA.

18. ADB DOC. R6-78 ON ABOVE SUBJECT WAS POUCHED  
JANUARY 18 AND WILL BE CONSIDRED BY BOARD OF DIRECTORS  
FEBRUARY 8. NAC QUIDANCE REQUESTED.  
EDMOND

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